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Nellie Akalp • Mar. 16, 2022



Can you help your S Corp clients determine a reasonable compensation?

What is an S Corp?

S Corps are corporations opting to flow their business income, losses, deductions, and credits through to their shareholders for federal tax purposes. S Corp shareholders then report the income and losses on their personal tax returns and are taxed at their individual income tax rates. One reason LLC and C Corp owners elect

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- Have only one class of stock

An S Corp isn't a legal business entity in and of itself. Rather, the S Corp designation is a special election made by an LLC or C Corp with the IRS that allows the business to offer the same liability protection as corporations and LLCs, protecting the owners' personal assets against debts and lawsuits of the company.

The S Corp Advantage

Besides liability protection and avoiding double taxation, S Corps have some other advantages:

- They are only required to file an income tax return once a year
- They can sell shares of stock, and
- They have perpetual existence, meaning the business continues to exist even if the owner leaves or dies.

The S Corp is also a popular entity election because it allows the owner(s) to divide business income into salaries and distributions. Owners pay payroll taxes on wages only, not on shareholder distributions. Dividends are the distributions from the business's income as a return of capital to a shareholder and are not subject to payroll taxes. For that reason, the IRS keeps a close eye on an S Corp's dividend distributions to ensure the corporation is not merely trying to avoid paying employment taxes.

What is Reasonable Compensation?

It can get messy if the IRS believes owners are trying to hide wages behind distributions to avoid paying payroll taxes. S Corp owners must pay "reasonable compensation" to each shareholder/employee in exchange for any services provided by the shareholder-employee. Defined by the IRS, "reasonable compensation is the

value that would ordinarily be paid for like services by like enterprises under like

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services to the company are required to receive wages—wages that are subject to federal employment taxes.

Although the definition of what constitutes a “reasonable” wage may seem subjective, the IRS scrutinizes the S Corp’s source of income—its gross receipts—and then determines if (and what tasks) the owner/shareholder performed for the S Corp to assist in generating the gross receipts.

Any portion of gross receipts generated by either the shareholder’s involvement or in the act of assisting employees in performing services must be compensated as wages and subject to employment taxes. The IRS recommends considering the following factors when determining the reasonableness of pay:

- The duties performed by the employee
- The volume of business handled
- The character and amount of responsibility
- The complexities of your business
- The amount of time required
- The cost of living in the locality
- The ability and achievements of the individual employee performing the service
- The pay compared with the gross and net income of the business, as well as with distributions to shareholders if the company is a corporation
- Your policy regarding wages for all employees
- The history of salaries for each employee

The [U.S. Bureau of Labor Statistics](#) compiles comprehensive wage data searchable by occupation nationwide, in addition to comparable wages by state, region, and city.

Filing for S Corp Status

To be treated as an S Corp, a corporation or LLC must complete and file IRS Form

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with comparable salaries in like positions as proof of reasonable compensation.

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Nellie Akalp is a passionate entrepreneur, business expert, and mother of four. She is the CEO of [CorpNet.com](https://corpnet.com), a resource and service provider for business incorporation, LLC filings, and corporate compliance services in all 50 states. Akalp and her team recently launched a partner program for accountants, lawyers, and business professionals to help them streamline the business incorporation and compliance process for their clients.

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